FINANCE ADVISORY COMMITTEE

March 1, 2001

Highlights

- *The majority of FAC Panelists believe the slowing in the Arizona economy is simply a return to normal rates of growth after a prolonged period of extreme growth. A recession is considered possible but unlikely.*
- *Some panelists recommended that the JLBC Staff lower its FY 2001 revenue forecast and suggested that the forecast for the next biennium employ average growth rates.*
- *Capital gains, which have been a big reason why income tax revenues have boomed over recent years, are expected to dry up, lessening the likelihood of another April surprise.*

How bad and for how long? Posed by Senator Solomon, this was the question on everyone's mind at the March 1st meeting of the Finance Advisory Committee (FAC). While most observers recognize that state revenue collections have slowed in recent months, there is keen interest in knowing how long the slowdown will last and how bad things will get. To answer this question, the JLBC Staff convened a meeting of its Finance Advisory Committee. The FAC is a 16-member panel of the state's leading economists from government, business, and academic settings. Several times a year the Staff calls a meeting of the FAC to receive expert advice on economic conditions and the revenue forecast. Panelists cautioned that the days of double-digit revenue growth rates are behind us and advised the Staff to employ a revenue forecast calling for growth to return to normal levels. Several of the committee members downplayed the likelihood of a recession in the Arizona economy, though they acknowledged that a recession is possible.

National Outlook

The opening presentation on the prognosis for the U.S. economy was given by Elliott Pollack, of Elliott D. Pollack & Company. Pollack gave a good news / bad news summary of the economy, warning "a slowdown is a certainty" and a recession possible. Reasons for optimism that growth will pick back up include low mortgage rates that make housing affordable, low unemployment rates, and favorable consumer demographics. Reasons for pessimism include sinking consumer confidence levels, high amounts of consumer debt, and tougher bank loan standards. As usual, the stock market is a wild card and remains difficult to predict, but it is clear that the decline in the market over the past year has stifled consumers' willingness to make large retail purchases. Pollack summarized his remarks by suggesting that even if the national economy does slip into a recession, the Arizona economy is unlikely to experience the negative growth that defines a recession.

Staff Presentation

Presenting next, the JLBC Staff detailed the status of FY 2001 revenue collections and described the revenue forecast for the next biennium. (A copy of this presentation is available on our web site.) The Staff explained that the January forecast calls for revenues to finish FY 2001 at a level of $100.7 million above the original budget forecast. Through February, revenues are $(9.0) million below the original forecast, making it increasingly unlikely that the state will meet January projections. Each of the economists elucidated a few points related to the major tax categories.

- Brian Schmitz commented on the remarkable run the sales tax had in the 90's, posting baseline growth rates of 9% or better in 7 out of the last 8 years. However, cumulative year-to-date growth in FY 2001 has only been 7.2%, compared to the January forecast of 8.1%. The slower sales tax growth in this fiscal year is mostly due to the November - January period, when growth averaged a sluggish 3.9%.

- Kent Ennis described revenue collections for the individual income tax. Like the sales tax, the individual income tax grew by leaps and bounds throughout most of the previous decade, but in FY 2001 the income tax has fallen short of expectations. Year-to-date collections are $(42.1) million below forecast, though it is believed that some of this deficit is due to early refunds. Poor stock market performance in 2000 makes the outlook for capital gains-related tax payments in April somewhat shaky.

- Jim Rounds called attention to the variability of the corporate income tax, which is easily the most volatile of the Big 3 revenue categories. Corporate income tax growth in FY 2001 has been outstanding, exceeding last year's total at this point by 22.3%. However, most of the growth occurred in the first quarter of this fiscal year. He also highlighted the R&D tax credit and its potential impact to the state.

- Hans Olofsson gave the outlook for the property tax. Property values continue to grow, and at an accelerating rate. It is expected that net assessed value will increase by 8.4% in FY 2001 – the highest growth rate in the current business cycle.

- Richard Stavneak wrapped up the Staff presentation by focusing attention on the differences between the JLBC forecast and the Governor's forecast. The two forecasts are the same in FY 2001, but the JLBC forecast is higher than the Governor's over the rest of the biennium. He asked the panelists for their perspective on whether we would make the FY 2001 forecast and whether the Arizona economy would quickly return to normal rates of growth. (Subsequent to the FAC meeting, both the JLBC and the Governor decided to revise their forecasts downward.)

State Outlook

Tracy Clark, of Arizona State University, presented the outlook for the state economy. Stating at the outset that he agreed with Pollack's view of national economic conditions, Clark opined that the Arizona economy would stave off recession but that slower growth is a certainty. Relative to other states, Arizona will continue to be among the leaders, though we will not be able to avoid the nationwide slowdown in tax collections. Over the next biennium, he expects car sales to moderate and for capital gains to dry up. When asked how long the slowdown will last, Clark indicated that unless the stock market rebounds, the period of slowing revenues will last through FY 2003.

The final formal presentation was given by Dan Anderson, of the Department of Economic Security, on labor markets. Anderson pointed out that Arizona job growth in January fell to 3.4%, down from growth of 4.3% in the prior January. This type of dropoff does not signal a recession; rather, it is merely a period of below average growth. Stressing his optimism about the Arizona economy, Anderson called attention to consumer confidence levels. Consumer confidence has fallen in recent months, in part due to a barrage of news media headlines about layoffs. However, these well-publicized layoffs have had little effect on total Arizona employment levels.

Other Issues

Besides the formal presentations, several of the other panelists weighed in on the issues and offered their opinion on the economy. Brian Cary, of Pinnacle West, thought that the economy would probably not recover in time for revenue collections to reach the forecast for FY 2001, but that the economy would soon after return to normal growth levels.

Marshall Vest, of the University of Arizona, summarized the condition of the economy by offering an interesting analogy. He likened the recent slowdown to the sensation you get after driving on the highway for a long time at high speeds and then exiting to a side street at a slower speed. The side street seems slow by comparison to the highway, even though you are still moving rather briskly. In the same way, the economy has just come off a period of extreme growth and is now moving along at more moderate levels. It may feel like a recession in comparison to the last 5 years, but the economy is actually fairly healthy. Several of the other panelists agreed with this interpretation of the economy. The national and state economies have returned to more normal levels of growth after an unusually long period of extreme growth.

Wally Duncan, of Northern Arizona University, offered an alternative view of the economy. He considers a recession probable, not just possible. Duncan expects the Federal Reserve Bank to lower interest rates by one-half to three-quarters of a percentage point this year in an effort to keep a recession from occurring.

Attendance at this meeting of the FAC numbered over 60 people, including 10 legislators.